HM Treasury

Financial Reporting Advisory Board

Climate Change Act implications for government financial reporting

Issue:	Richard Barker, FRAB member, brings this paper to the Board for its consideration of the potential implications of the Climate Change Act 2008 on government financial reporting.
Impact on guidance:	Potentially going forward
IAS/IFRS adaptation?	N/A
Impact on WGA?	To consider
IPSAS compliant?	N/A
Interpretation for the public sector context?	To consider
Impact on budgetary and Estimates regimes?	Potentially going forward
Alignment with National Accounts	To be confirmed
Recommendation:	The Board is to consider the issues raised in this paper and the proposal to form a FRAB working group to take the matter forward.
Timing:	Ongoing.

<u>The Climate Change Act (2008) - Implications for Government Financial Reporting?</u>

Introduction

This draft 4 March 2021[1]

1. The question in this paper is whether the Climate Change Act (2008) - the 'Act' - has implications for Whole of Government Accounts (WGA) and, more generally, for government financial reporting. This question is not just technical but also very much of public interest, given the scale of climate-related economic risks.

2. It is one thing for the government to have declared a climate emergency, it is another for the associated financial accountability to be in the public domain and so the subject of appropriate attention. Meanwhile, the tensions between economic planning and environmental commitments are increasingly part of the public and political dialogue, for example over HS2, Heathrow expansion, and the Lower Thames Crossing. A French court last month ruled against its government over failure to meet climate commitments, and the same can increasingly be expected in the UK.

3. **It is <u>recommended</u> that the FRAB should establish a working group, or similar mechanism, to explore the issues in this paper further and to report back to future meetings. The FRAB may also wish to discuss any of these issues at the current meeting, not least to add to, or correct, any of the points made below, and to help frame the remit for a possible working group.**

4. The paper is structured as follows:
   Context
   a. The Climate Change Act (2008)
   b. Developments in Corporate Reporting
   c. Illustrative examples

   Financial Reporting Issues
   i. Does the Act apply to the government?
   ii. Does the Act constitute a target or a commitment?
   iii. Is there measurability?
   iv. Must there be contracts to undertake the work?
   v. Is there an asset impairment?
   vi. Should there be recognition of a liability?
   vii. Should there be disclosure?

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CONTEXT

The Climate Change Act (2008)

5. The Climate Change Act sets legally binding targets to reduce greenhouse gas ('carbon') emissions in the UK to net zero by 2050, with the associated duty sitting with the Secretary of State. The UK is the first country to legislate in this way.

6. Relevant provisions of the Act include the following.

- The duty, in Section 4.1, is 'to set for each succeeding period of five years beginning with the period 2008-2012 ("budgetary periods") an amount for the net UK carbon account (the "carbon budget"), and to ensure that the net UK carbon account for a budgetary period does not exceed the carbon budget.'[2]
- Section 4.3 specifies a duty on the Secretary of State 'to explain how the proposals and policies set out in the report affect different sectors of the economy.'
- Section 13 specifies a duty 'to prepare proposals and policies for meeting carbon budgets.'
- A reporting duty in Section 56 is 'to lay reports before Parliament containing an assessment of the risks for the United Kingdom of the current and predicted impact of climate change.'

7. The Act also established the Committee on Climate Change ('CCC'), to advise the government. In May 2019, that committee recommended that the 2050 target should be tightened, from its original target of an 80% reduction from the level in 1990, to an absolute target of zero net emissions, at an estimated cost of 1-2% of GDP, or tens of billions of pounds. Legislation to that effect was passed in June 2019, with very strong cross-party support. The environment secretary Michael Gove added that 'the situation we face is an emergency, it is a crisis, it is a threat that all of us have to unite to meet.'

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[2] An issue of possible accounting and reporting consequence concerns whether the budgets themselves are met. The CCC notes that: 'UK emissions were 44% below 1990 levels in 2018. The first carbon budget (2008 to 2012) was met, as was the second (2013 to 2017) and the UK is on track to outperform the third (2018 to 2022). However, it is not on track to meet the fourth (2023 to 2027) or the fifth (2028-2032). To meet future carbon budgets and the Net Zero target for 2050 will require governments to introduce more challenging measures.'

Developments in Corporate Reporting

8. The scope of financial reporting is currently very much in debate. The IFRS Foundation is consulting on whether to create a Sustainability Standards Board (SSB), to sit in parallel with the IASB. Similar to the IASB, the primary focus for the SSB would be financial materiality, in other words providing information relevant to investors' determination of enterprise value.

9. A very closely related initiative to that of the SSB is the Task Force on Climate-Related Financial Disclosure (TCFD), which also seeks to provide financially material information outside of financial statements themselves.

10. More broadly, the concept of 'double materiality' is finding traction in rapid developments within the EU, relating to the Non-Financial Reporting Directive, the Taxonomy, and the proposal that EFRAG should set sustainability reporting standards. A parallel in the UK is that the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 requires all UK quoted companies to report on their greenhouse gas emissions as part of their annual Directors' Report.

11. Meanwhile, the UK is currently in the spotlight, as host later this year of the UN Climate Change Conference, COP26. The timing is ideal to demonstrate leadership on governmental climate-related financial disclosure. In this regard, financially material information could be provided either in the financial statements (including notes) or in disclosures that supplement the financial statements.

Illustrative examples

12. In order to illustrate how the net zero targets might be met, and therefore what the financial reporting implications might be, the two examples below will be used in this paper. These are simplified illustrations, where it is assumed that net zero is met either by reduced dependence on fossil fuel as a source of energy (in transportation and in heat generation; hereafter 'Energy') or through greater thermal efficiency (building insulation; hereafter 'Insulation'). How the net zero target will actually be met in practice is beyond the scope of the paper, though for information the CCC identifies the following sectors in its analysis of the transition to a net zero carbon economy: surface transport; buildings; manufacturing and construction; electricity generation; fuel supply; agriculture, forestry and land use; aviation; shipping; waste; F-gases; and greenhouse gas removals. The illustrations below relate to the first two of these sectors.

13. Example 1 assumptions - Energy. The government operates a fleet of diesel vehicles. These are all due to be replaced by electric vehicles by 2050. Similarly, the boilers in government buildings are mostly due for replacement before 2050, although some boilers have a long expected useful life, and - to meet the carbon target – they may need to be retired early.

14. Example 2 assumptions - Insulation. The government has a large portfolio of buildings that are energy inefficient. The example of hospitals will be used here. The hospital buildings all have an expected useful life that extends beyond 2050. These buildings will need to be retrofitted in order that the carbon emission targets can be met. This retrofitting will involve phased, costly shut-downs of different departments of the hospital, in order to allow for the replacement of windows and doors, stripping of walls to allow insulation to be added, and in the process asbestos removed, and so on. None of this work would be done in the absence of the Act. By assumption, the cost exceeds expected future benefits from lower energy usage, and there are no other benefits from the retrofitting that enhance the services provided by the hospital.

FINANCIAL REPORTING ISSUES

15. The remainder of the paper is structured as follows. Each section raises a specific financial reporting issue. At the start of each section, in italics, is a brief argument against the need for any form of financial reporting. This is followed by a discussion of the validity of that argument. At the end of each section, and underlined, is the conclusion that is reached. The conclusion applies to the specific issue under consideration only; it is not a general statement.

16. The identified financial reporting issues are as follows:

- Does the Act apply to the government?
- Does the Act constitute a target or a commitment?
- Is there measurability?
- Must there be contracts to undertake the work?
- Is there an asset impairment?
- Should there be recognition of a liability?
- Should there be disclosure?

i. Does the Act apply to the government?

17. *The Act applies to the UK as a whole, whereas the WGA are the accounts of the government only. The cost of meeting the climate targets will be borne by companies and households, not just by the government. In principle, it is*

possible that the targets can be satisfied without any change within government itself, and it is therefore not evident that the government's financial reporting is affected.

18. Given the scale and permanence of the government within the economy, along with the extent of its carbon emissions, it is implausible that net zero can be achieved without change within government itself. The obligation is not avoided on the grounds that it is shared with the private sector. In any event, a presumption to the contrary could not be justified without first attempting quantification or other evaluation.

Conclusion: The Act is, in principle, relevant for government financial reporting.

ii. Does the Act constitute a commitment, or is it instead just a target?

19. *Future parliaments are not bound by the decisions of current parliaments – legislation can be repealed – and so the Act is in effect a target, not a commitment. It therefore has no current financial accounting implications.*

20. Companies are not automatically bound by statements of intent, nor even by Board decisions; for example, the discussion of restructuring in IAS 37 makes clear that a Board decision is not enough to create a liability. This conclusion would apply equally to policy statements made by the government.

21. In the case of the Act, however, the issue is not a policy target but instead a legal obligation: the government has made a commitment to be bound by law. If this was no different from target setting, then legislation would be an empty step.

22. Moreover, the argument that the law can be repealed is problematic, for two reasons. First, the possible future repeal of the law doesn't describe conditions at the balance sheet date. Second, the argument applies equally to obligations that, in practice, are recognised in the WGA; there could, in principle, be repeal of the legal requirement to decommission nuclear power stations, yet provisions are in the WGA.

23. A further argument is that there is no liability unless the law has been broken, and the government thereby becomes exposed to any fines or litigation that are likely to succeed. The expected course of action, however, is compliance with the law rather than breach, and accounting practice is not generally based upon what is unlikely to happen. In any event, this argument would presumably suggest not providing for nuclear decommissioning, but instead waiting for the escape of radioactive material before recognising a liability.

24. Another argument still is that the government can raise future taxes to cover the cost, which is in effect an unrecognised, and offsetting asset; yet, here also, the argument applies equally to nuclear decommissioning.

25. Conclusion: The Act imposes a legally binding commitment on government, and it is therefore in principle a relevant consideration for government financial reporting.

iii. Is there measurability?

26. *The costs of meeting the carbon commitment cannot be measured reliably, not least because the changes that need to be made (and the technologies) are not yet clear.*

27. This 'too difficult to measure' argument is difficult to sustain. It seems unlikely, for example, that the costs of transitioning to net zero have greater measurement uncertainty than those associated with the major provisions that are already recognised in the WGA, relating to nuclear decommissioning and pension obligations. Moreover, the required five-year carbon budgets imply a relatively high degree of specificity in the short to medium term. Meanwhile, the technology required to comply with the Act is no more uncertain than it is for nuclear decommissioning, and the uncertainty associated with long forecast periods no greater than for pension obligations.

28. In any event, and as with the above question of scope, a 'too difficult to measure' conclusion cannot be reached without an attempt at measurement first being made. And even if 'too difficult to measure' was indeed concluded, some form of disclosure of an estimated range might then be appropriate, rather than no disclosure at all.

29. In this regard, there is considerable sectoral analysis undertaken by the Climate Change Committee, which could provide a basis for estimating the allocation of the overall net zero obligation that falls on the government, and the activities within government that are most directly affected. In turn, this could provide a basis for estimating current and future financial implications. Such granularity is to some degree a requirement of the Act.

30. Conclusion: There is not a strong *a priori* case that the challenge of measurability precludes either financial accounting and/or climate-related financial disclosure relating to the Act.

iv. Must there be contracts to undertake the work?

31. *Contracts have not yet been signed, and there is therefore nothing as yet to account for.*

32. If two different entities face the same legal obligation, they would not be expected to account differently if one of them had signed a contract for work to satisfy the obligation, and the other had not. In the WGA context, contracts for the future decommissioning of nuclear power stations are presumably largely unsigned, which has no implications in determining whether a provision should be recognised. The absence of an agreed supplier does not imply the absence of a liability.

33. A possible, practical issue here - a separate point, but related - is that the absence of contracts might create a degree of ‘invisibility’ of future costs. The WGA are prepared bottom-up, from the accounts of each department, while the Act is in effect is top-down, and so maybe it has not crystallised at the level of departmental accounting.

34. Conclusion: Whether or not contacts have been signed is not relevant from an accounting perspective.

v. Is there an asset impairment?

35. *The Act does not affect the operating capability of any assets in the government's balance sheet, instead it just changes future capital expenditure; there is therefore no impairment.*

36. If legislation requires replacing the diesel transport fleet and the boilers, and if this can be done within the normal operating life of these assets, in a way that meets emissions targets, then the implication is that future capital expenditure plans are constrained, and possibly more expensive, but there is no implication for currently-recognised assets.

37. Of the two illustrative examples provided earlier, it is only in the case of long-lived boilers that there is the possibility of an impairment loss due to a shortening of useful economic life. This might also apply to boilers that could, in principle, sustain a much longer useful life, but which are being phased out early

as part of a (necessarily) long transition period leading up to 2050. Much the same effect – albeit, no doubt, of much greater economic consequence – was presumably recognised by the German government, following the decision (after Fukushima) to discontinue the generation of nuclear power.

38. It is possible that some impairments of this kind are being made already, albeit within the 'normal' cycle of PPE accounting. If so, they are simply being applied whenever an asset is withdrawn early, and not explicitly categorised under a 'climate change' banner.

39. Conclusion: The Act might require the impairment of assets in WGA. This would apply where the useful economic life of existing assets is reduced in order to meet the carbon budget.

vi. Should there be recognition of a liability?

40. *Carbon targets are set with respect to future emissions. The commitment to meet those targets does not, therefore, arise from a past event, and so there is not a present obligation.*

41. The Conceptual Framework defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.' Assuming that there is an expected outflow resulting from the Act, the issue at stake here is whether there is a present obligation with respect to that outflow, which requires identifying a past event. This, under IAS 37, would be an obligating event, 'an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.'

42. The Conceptual Framework (para 4.45) states: 'If new legislation is enacted, a present obligation arises only when, as a consequence of obtaining economic benefits or taking an action to which that legislation applies, an entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.' The wording could be clearer. If, however, "taking an action to which that legislation applies" can be understood to mean "as a consequence of … already having taken an action," then (for example), if new decommissioning legislation applies to a nuclear plant that had already been built (i.e. the action occurred before the legislation), then there is a liability as soon as the legislation is enacted, and thereby a requirement to provide for decommissioning. It is presumably not the plant itself to which the legislation applies, however, but instead its operation, through which radioactive contamination is generated. By means of capitalisation on initial recognition of the plant, the cost of that

pollution is expensed over time, as the plant operates, while the provision remains. The (net) liability therefore increases, representing the growing obligation to 'make good' environmental damage that has already occurred, but not that which has yet to occur. In the language of IAS 37, the obligation is 'to rectify damage already caused.'

43. IAS 37 provides an example relating to environmental legislation, where (under new legislation) an entity is required to fit smoke filters to its factories by 30 June 20X1. As at 31 December 20X0, the entity had not fitted the smoke filters. It is argued not to have an obligation at that date because there is no obligating event, either for the costs of fitting smoke filters or for fines under the legislation. While there is a (new) need to replace/update assets, the implication of that legislative requirement is for higher future capital expenditure, not a requirement for the entity to recognise a provision now. In contrast with the above example of nuclear power, the issue is concerned not with the past actions of the entity, but instead with events that lie ahead. To the extent that the Climate Change Act also relates to achieving a future state, rather being held accountable for past actions, the implication seems to be that the Act should not trigger the recognition of provisions in the government's accounts; the legal requirement is to achieve net zero by 2050, and not 'to rectify damage already caused.'

44. Yet the analogy is imperfect. In the smoke filter example, the legislation can be avoided if the company exits that part of the business to which the legislation applies. It would thereby never have an obligation to fit smoke filters. In the language of IAS 37, 'the entity can avoid the future expenditure by its future actions,' and it should therefore not recognise a liability. When applied to the government's carbon emissions, however, this argument becomes hard to maintain. All of the government's activities emit carbon, and its carbon target remains whatever activity it is engaged in. The government does not have the option of not operating in the future, and many of its assets (such as hospitals) do not have an alternative use and are dedicated to the specialised and ongoing provision of a service. And since the government cannot 'exit the business', it does not, in substance, have a 'realistic alternative' to incurring the costs imposed by the requirements of the Act.

45. Moreover, the requirements of the Act are not independent of past events. It is a consequence of past greenhouse gas emissions that legislation is required to reduce future emissions to net zero. And in the (very) long run, the effect of no longer adding greenhouse gases to the atmosphere would be to reduce their concentration to pre-industrial levels. In this respect, there is little difference between nuclear and carbon. Both involve past actions, associated with the

operation of capital equipment, that have the potential to lead to harmful atmospheric pollution. In the case of nuclear, the potential harm is contained by means of decommissioning, which is costly. In the case of carbon, the potential harm is (ultimately) contained by means of transitioning to net zero emissions, which is also costly. While the legislative solution is different for nuclear than it is for carbon, because the pollution dynamics are themselves different, the need for legislation in both cases arises from past events that risk causing damaging pollution and that are costly to rectify. In the words of IAS 37, the Act, in effect, imposes 'clean-up costs for unlawful environmental damage.'

46. A complementary perspective is to note that, in contrast with the smoke filter example, where installation is presumably not a major project, the government cannot wait until 2050 before it starts to meet its obligations under the Act; the scale of the task is too large and so, in the words IAS 37, there is 'no realistic alternative' to actions already being underway. It would therefore be meaningless to argue, as the smoke filter example implies, that a liability should be recognised on 1st January 2050, but not on 31st December 2049.[3] Moreover, those actions are needed because past actions have not only emitted carbon, but they have also resulted in infrastructure and other asset investment that must be significantly transformed in order ultimately to comply with the Act. Even acknowledging that the legislation relates to future emissions that have not yet taken place, the obligation in substance is to 'make good' an existing operating model that results from past decisions.

47. There is perhaps a better analogy with a different illustrative example in IAS 37, namely that of restructuring (Example 5B). IAS 37 includes within its definition of restructuring 'fundamental reorganisations that have a material effect on the nature and focus of the entity's operations' (para. 14). This is consistent with the transition to net zero. Para. 72 of IAS 37 notes that a constructive obligation to restructure arises only when, first, an entity has a detailed formal plan for the restructuring and, second, when it has raised a valid expectation in those affected that it will carry out the restructuring. The latter requirement is surely met in the government's case by it having passed a legally binding Act, while the former arguably differs only in that the discussion in IAS 37 frames restructuring as a short-term endeavour, not as a 'project' on a national scale lasting until 2050. That said, the CCC arguably does provide a detailed formal plan, albeit in this much broader setting, and while it might be argued that the concept of

[3] A further breakdown in the analogy is that failure to fit a smoke filter could be expected to result in a fine, which would meet the definition of a liability. There is no direct equivalent for the government in failing to meet legislative requirements. The logic of the smoke filter example could therefore be used to argue that the government has neither a liability before 2050, nor a liability after.

restructuring applies only to each five-year carbon budget in turn, the substance is that net zero transition is a single project, lasting until 2050.[4]

48. The analogy with restructuring is further applicable in that there is a 'one off' cost in transitioning to a different operating model, as opposed to an anticipation of future operating expenses associated with 'running the business'. In this regard, the Act is onerous. In the hospital example, the government is worse off at the balance sheet date as a consequence of the legislation having been enacted. The legal requirement is for whatever capital expenditure (and associated operating cost) is required to avoid future pollution, and not to enhance the service potential of the hospital with respect to providing services to patients.

49. Conclusion: The question of whether the Act should lead to the recognition of provisions is difficult to settle without further investigation. It would be hard to defend an *a priori* presumption that provisioning should not be considered. While IAS 37 provides considerable guidance, the time scale and complexity involved in implementing the Act raises issues that were not considered explicitly when IAS 37 was drafted.

vii. Should there be disclosure?

50. If there is no recognition, there is no need for disclosure either.

51. As discussed above, there are open issues concerning the recognition and measurement implications of the Act. Whichever way these are resolved, there will inevitably also be financially material consequences of the Act which do not fall within the scope of financial accounting, particularly those concerned with the types of disclosure associated with TCFD, and with similar initiatives such as the sustainability reporting standards being considered by the IFRS Foundation.

52. This raises broader issues of how best to integrate government financial reporting, relating in the current context to: first, the Secretary of State's obligation to set out carbon budgets, and to report progress against them; second, the Climate Change Committee's role in reporting in detail on carbon budget planning and performance; and, third, HM Treasury's role in presenting

[4] The reasoning here is supported by Para. 74: 'For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.'

the WGA and associated narrative. The effective integration of these different forms of reporting is especially important given the scale and urgency of climate change.

53. Conclusion: The financial reporting implications of the Act extend beyond WGA, raising broader questions of financial reporting by HM Treasury, and how this integrates with other spheres of complementary government financial reporting, and also with current developments in the scope of IFRS.